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28 June 1974

MEMORANDUM FOR THE RECORD

SUBJECT: Impact of High Oil Prices on Inflation and Output

On 28 June, a report on the impact of high oil prices on inflation and output was forwarded to Treasury Secretary William Simon [redacted] STAT

[redacted] was the author of this unclassified study.

STAT

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IMPACT OF HIGH OIL PRICES ON INFLATION AND OUTPUT

SUMMARY

The sharp rise in oil prices has greatly worsened the economic outlook for the non-communist world. It has caused sharply higher rates of inflation in industrial countries while also causing a slump in industrial output and sharply reducing consumers' real incomes. Over the next year or so, output is likely to remain depressed while inflation continues at a rapid rate. In the longer term, economic growth rates will be much slower than in the past, as resources are used to reduce oil consumption rather than to expand capacity. Because of high energy prices' impact on food production and slowed productivity gains, inflation is likely to continue at a rapid rate.

In the developing countries the impact will be even more severe. Since they have little scope to reduce oil consumption or develop alternative energy sources, continued high oil prices will force them to reduce capital goods imports and slow their economic growth. For some of the poorer countries -- these already facing great difficulties feeding their burgeoning populations -- the impact will be particularly cruel. They have been relying upon increased fertilizer application to boost farm output, and they

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could face enlarged food shortages. Since world food stocks are depleted, any sizeable drop in food production could result in regional famines. If some relief is not soon forthcoming, their continued solidarity with oil producers in international forums is doubtful.

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IMPACT OF HIGHER OIL PRICES ON INFLATION AND OUTPUT

1. The rise in oil prices since October 1973 has sharply dimmed growth prospects in the world's major industrial countries and greatly added to inflationary pressures (See Figure 1). These countries now have to pay an additional $60 billion annually for their oil imports. The contractionary impact on consumer purchasing power has been reflected in a downturn in world industrial output in recent months. The slump has been particularly marked in durable consumer goods industries (See Figure 2).

2. World industrial output probably will suffer a further severe drop in the months ahead with some countries hit harder than others. Thus far, retail sales have slumped much more sharply than output, leading to a rapid growth in business inventories in most countries (See the table). Because of the need to reduce these excessive inventories, there is a real danger of a further drop in industrial output. This would cause a further downward spiral in demand and output. Moreover, because high-priced oil will radically shift the allocation of new investment, economic growth will slow over the long run as well.

3. Higher oil prices have greatly accelerated the pace of world inflation (See Figure 3). In addition to its direct impact on consumer prices, high-priced oil has sharply boosted industrial costs and prices. This is bringing about a wage explosion in industrial countries, as workers strive to recoup real income losses. This in turn will boost prices still more, since these wage increase will be reflected in higher unit-labor costs. Productivity already has been depressed by the contractionary effect of high oil prices.

4. Burgeoning trade deficits have severely limited the options open to economic policymakers in the industrial nations. Italy and Denmark are having great difficulty financing their oil payments and have strengthened their restrictionary policies. Japan has squeezed its economy so tightly that GNP fell 5% in the first quarter of the year. Expansionary fiscal and monetary policies would stem the slump in consumer purchasing power and output. Such action, however, would also worsen balance-of-payments crises unless nations expanded in concert.

5. Financing large trade deficits is proving to be difficult and expensive, in part because of lenders' insistence on highly liquid investments. As a result, the industrial nations are all simultaneously taking steps to further restrict demand. Restrictive policies

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will greatly aggravate the slump in output -- already the worst since the 1930s for some countries -- and delay recovery.

LONG-TERM EFFECTS OF HIGH OIL PRICES

GROWTH AND ENERGY DEMAND

6. The present high level of oil prices will have far-reaching consequences for the world economy. Future output growth will be much slower than in the past. Because high oil costs will shift investment into development of alternative energy sources and energy-saving manufacturing processes, new additions to industrial capacity will be limited. Japan, for example, is planning to restrain output until late 1975 -- holding growth close to zero -- and then planning for output rises of only 5-6% annually, compared to the 9-10% average of the past decade. In addition, the composition of consumer demand will shift away from high energy-consuming goods.

7. The result will be a slow rate of economic growth and an even slower rate of growth in energy consumption. Alternative energy sources probably will grow faster than total energy demand. World oil demand will be hard-hit and oil import demand will probably fall. Germany and France, Europe's biggest oil consumers, have developed plans to greatly reduce the future rate of growth of

energy consumption. These plans also call for a much greater reliance on nuclear energy and an actual reduction in oil imports over the next decade. Because of growing North Sea and Alaskan output, import needs will fall in both the UK and the US, even if they do not restrict consumption as severely as Germany and France.

INFLATION

8. The outlook for a substantial slowing in the current high rate of inflation is poor. Indeed, the next few years are likely to witness a continuation of recent trends toward both higher inflation and unemployment (See Figure 4). The outlook is particularly poor because of the impact of high energy costs on the extremely tight world food situation.

9. Agriculture, particularly in the developed countries, is highly dependent upon large amounts of energy-based inputs, especially nitrogen fertilizer. Fertilizer shortages already have contributed to higher food prices.. Because of the quadrupling of oil-based fertilizer prices, food prices will have to undergo a further-hefty increase if farmers are to be induced to maintain application rates and yields. Continued rapid increases in food prices, in turn, will fuel large wage demands in industry.

10. Several factors will serve to boost industrial prices as well. Because of slower capacity growth, any upturn in demand resulting from a reversal of current demand-management policies would run into capacity constraints and further increase inflationary pressures. Given the highly unionized structure of manufacturing and the current push by labor to recover losses in real income, higher wage costs will be built into future manufactured goods prices. The impact of higher wages is likely to be more severe than in the past because of reduced productivity gains, which traditionally have offset much of the rise in wage costs.

IMPACT ON THE DEVELOPING COUNTRIES

11. The impact of high oil prices on the developing countries is particularly severe. These nations have little scope for economizing on oil use without reducing production of essential goods, since only a very small amount of their consumption is frivolously consumed. The impact has been particularly cruel in those countries that have been depending upon modern fuel based inputs to boost food production. Fertilizer price rises and shortages have dimmed the crop outlook this year, as have shortages of fuel for tractors and trucks in rural areas.

12. Several of the poorer developing countries have been walking a thin line in trying to feed their burgeoning populations. Most recently they have pinned their hopes to the new high-yielding varieties, which required carefully measured and timed fertilizer applications. The recent disruption of fertilizer supplies and skyrocketing prices may help push some of those countries over that line. Because world grain stocks are at their lowest levels in the last 20 years, traditional exporters such as the US do not now have supplies to provide to avert famine if crops fall short this year.

13. The long-run impact on the developing countries will be severe even for those who do not face immediate difficulties in feeding their population. The oil price augmented slumps and inflation in the industrial countries will rebound with doubled force against the developing nations. Slower growth in the industrial countries will inevitably result in reduced demand for LDC exports of raw materials and declining raw material prices. The current efforts by many groups of raw material suppliers to emulate OPEC will probably fail, particularly if demand remains depressed for a substantial period. At the same time, inflation will continue to boost the cost of their imports of capital goods and food.

14. The result will be much slower growth and a widening of the already large gap between developing and developed nations. Although the developing countries are pressing the industrial states for more aid, it will soon become apparent to them that their plight is not likely to be significantly eased by increased lending from the industrial countries, who will continue to face great balance of payments and employment problems.

15. The result will doubtless be a growing awareness by developing nations that high oil prices must be reduced. Developing nations will soon identify the oil producers as the source of the world's economic ills, and begin to oppose them in international forums.

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FIGURE 1

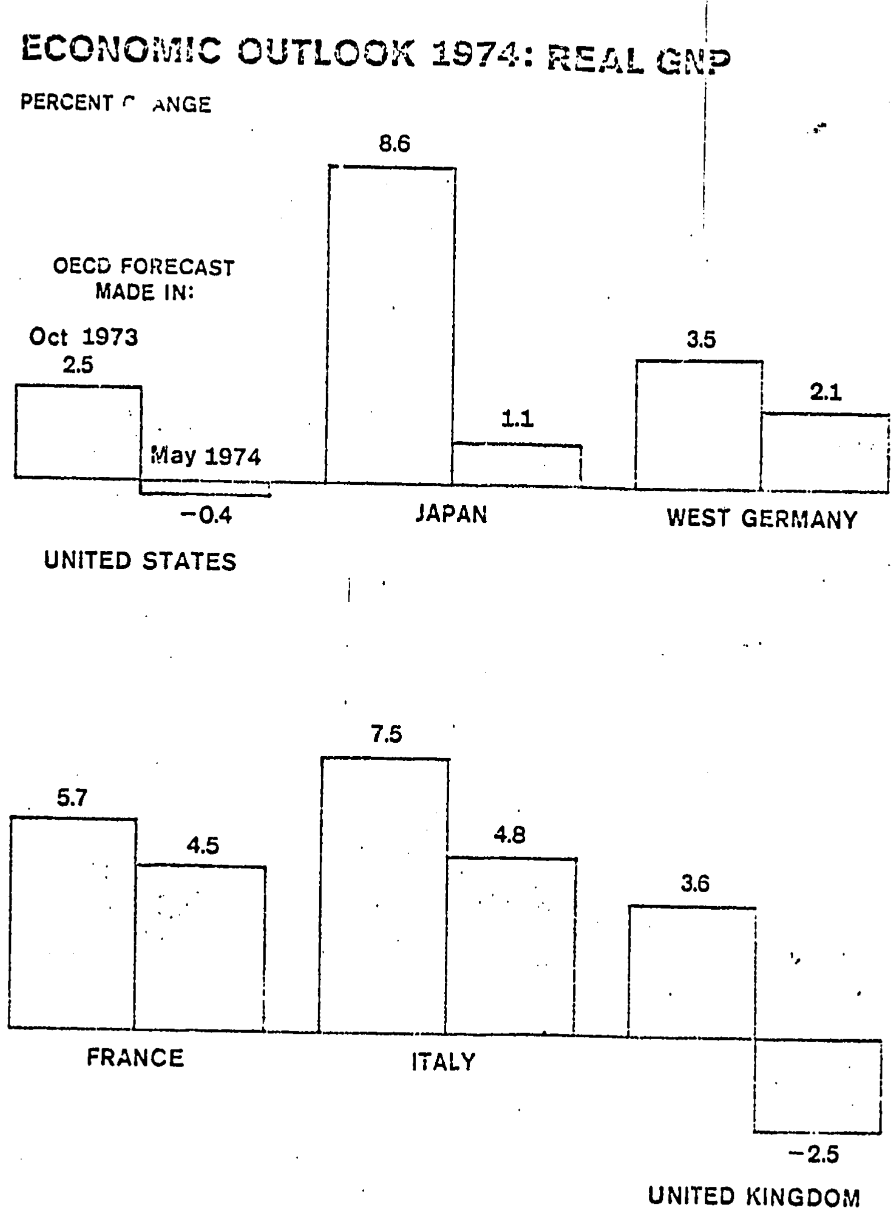

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FIGURE 2

INDUSTRIAL PRODUCTION DECLINES

PERCENT CHANGE NOVEMBER 1973-MARCH 1974

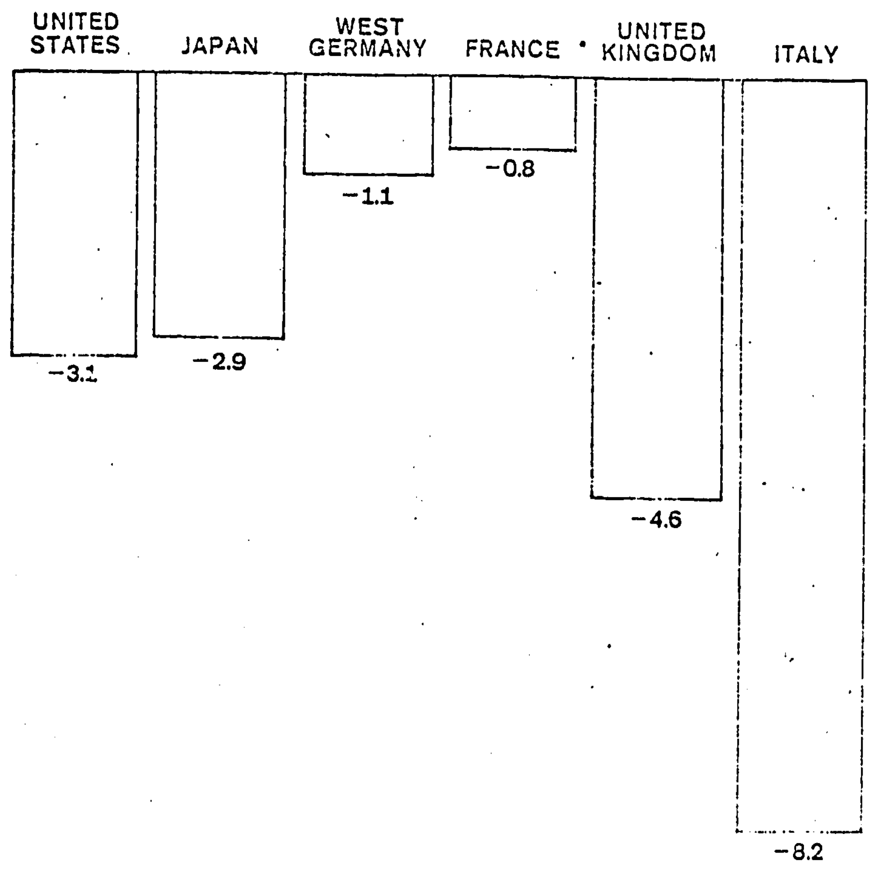

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FIGURE 3

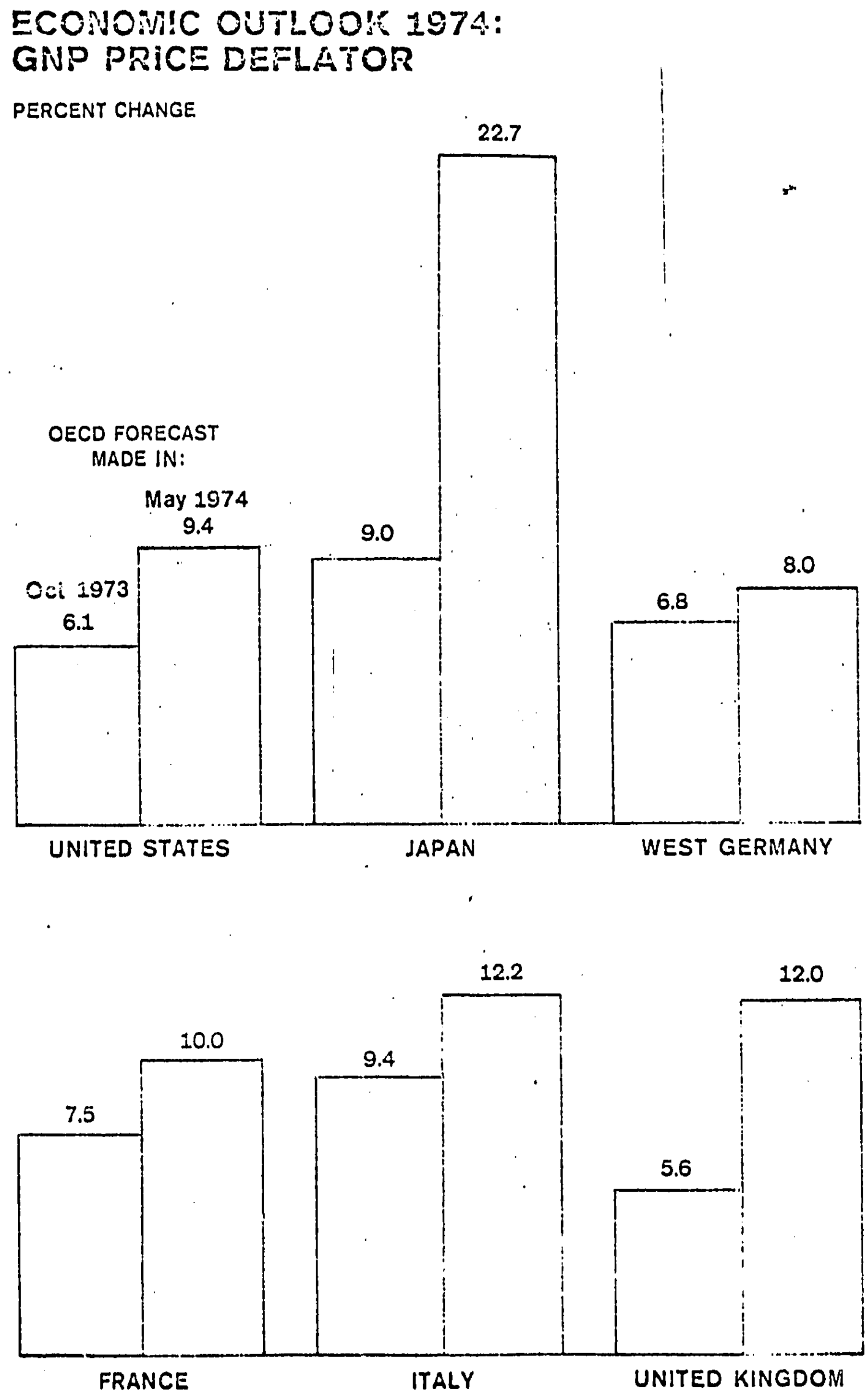

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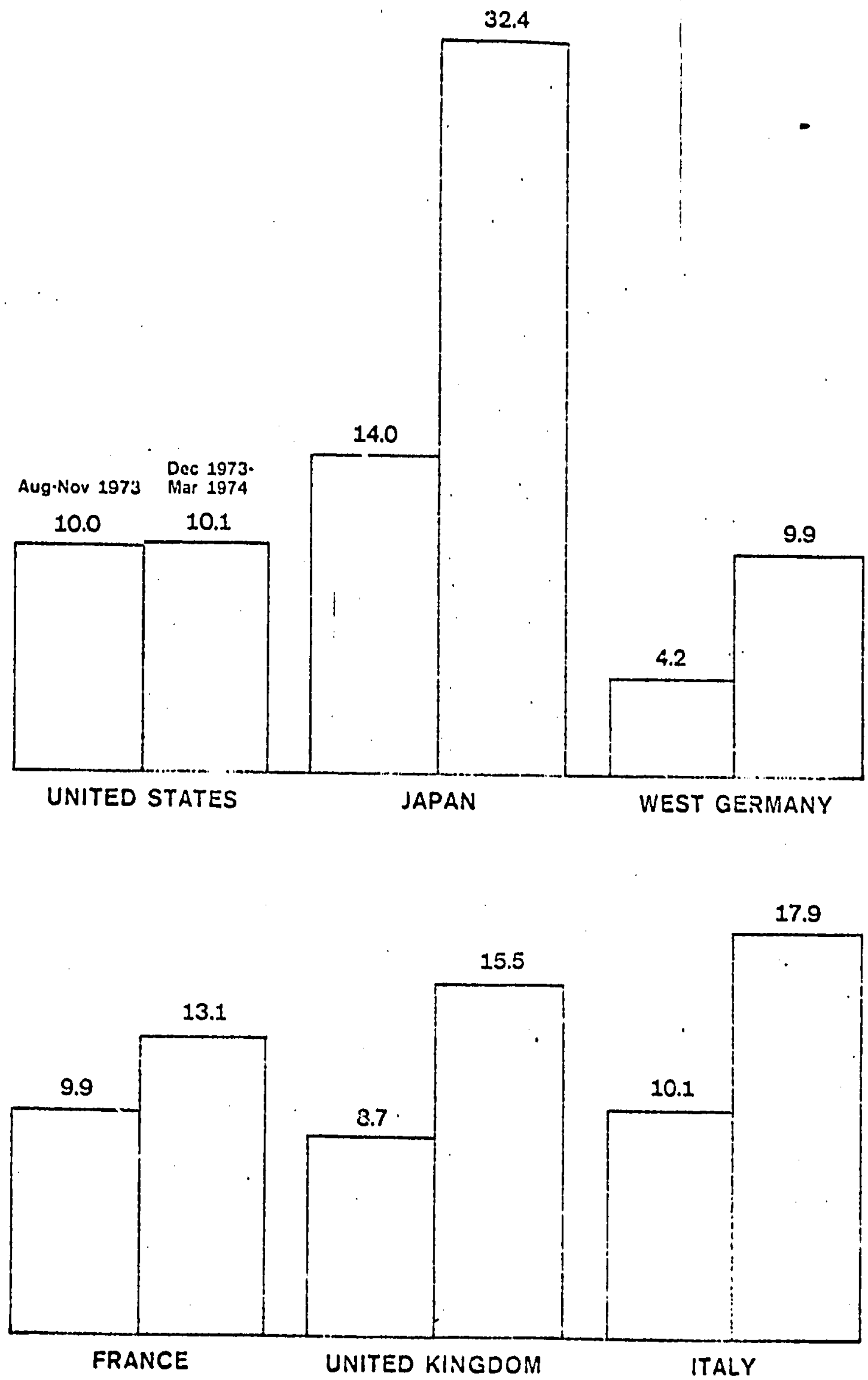
FIGURE 4

CONSUMER PRICE TRENDS

PERCENT CHANGE FROM PREVIOUS PERIOD, ANNUAL RATES



CHANGES IN VOLUME OF RETAIL SALES* AND INDUSTRIAL PRODUCTION

LATEST 12 MONTHS

	PERCENT CHANGE	
	Retail Sales	Industrial Production
United States	-3.5	+0.4
Japan	-5.8	+3.3
West Germany	-5.9	+1.1
France	-3.0	+5.1
Canada	+0.8	+3.6

*Sales deflated by consumer prices

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